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Alliance Boots' Leveraged Buyout:
Is KKR a true Barbarian at the Gate?

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Abstract

This case study discusses the leveraged buyout (LBO) of Alliance Boots, a multinational company operating in the pharmaceutical, health and beauty industry. The case is particularly focused in the investing part of the private equity cycle and, more specifically, on the motivations for a LBO, on private equity returns and on the relationship between pricing under a competitive bidding process and limited partners' returns. In March 2007, a consortium composed by KKR and Stefano Pessina intended to buy Alliance Boots, however there was another bidder who also wanted to acquire the firm. In face of this competitive market situation, KKR and Pessina had to decide whether to increase the offer price to acquire the firm, while guaranteeing good future returns.

Keywords: Private Equity, LBO, Bidding War.

Case Study

Introduction

The previous days had been though for Dominic Murphy, KKR’s Head of the Healthcare industry team in Europe, and for Stefano Pessina, Executive Deputy Chairman of Alliance Boots. Sitting on the conference room of KKR’s UK office, they were gazing at the projections for a potential investment. Their minds revolved around Alliance Boots, a multinational company operating in the pharmaceutical, health and beauty industry and a key question had to be answered: should they increase the offer price to buy this company?

In 2007, Pessina, backed by KKR, intended to acquire and delist the newly merged firm and to improve its operations, announcing a potential offer for the shares of Alliance Boots at a 15.9% premium above the March 8th day's close of £8.15. However, another private equity consortium, led by Terra Firma Capital Partners, also intended to take the opportunity to acquire Alliance Boots. Hence, an intense bidding war followed, which increased the offer price, leading to a final bid of £11.15 per share – a 36.8% premium offer over the undisturbed share price – made by Terra Firma’s consortium.

KKR had just finished the fundraising for its biggest fund ever – *KKR 2006 Fund* – which would be used to finance part of the Alliance Boots takeover. This fund had a committed capital of $16.6 billion and the LPs who invested in this fund were expecting a good return on their invested capital. Murphy felt the pressure to make a final and decisive offer to put an end to the bidding war, while preserving good return prospects for the LPs, whose money had to be "put to work". So, while a higher price would achieve victory, it would come at a cost for the LP's IRR.

Murphy and Pessina had to arrive at a decision soon, so that the Board of the target firm could discuss and decide the outcome they believed served best their shareholder's interests. They needed to raise their bid if they wanted to takeover Alliance Boots; yet, they had to keep in mind whether a higher bid would deliver good returns.

The Players

KKR

KKR was founded in 1976 in the United States, where the core of its operations stood, by three partners - Jerome Kohlberg Jr., Henry Kravis and George R. Roberts. Since its creation, the firm specialized in leveraged buyout transactions, and by 2007 its first ten traditional private equity funds had invested $30 billion in more than 150 transactions. These funds had generated a return value of $74.4 billion, from which 75% was already realized and distributed to investors in the form of cash.[1] With $44.1 billion of assets under management, KKR was one of the largest private equity funds in the world. Since its inception, the firm was responsible for several key transactions in its industry, such as the one of RJR Nabisco in 1989, which represented the biggest leveraged buyout by that date, earning KKR the title of *Barbarians at the Gate* **(Exhibit 1)**.[2]

KKR was one of the most experienced private equity firms, known for its aggressive approach in the deal making process and for being opportunistic when playing with debt. The sourcing, selecting and due diligence processes, jointly with the team and investor base, were its key value drivers. The firm specialized itself in several industries across different regions in the world, being Business Services, Retail, Energy, Financial Services, Healthcare, Utilities and TMT its core target industries in Europe, where it had been an active investor.

From 1976 to 2007, KKR had sponsored and managed 14 private equity funds, mainly focused on large cap firms, with an aggregate committed capital value of $56.9 billion, and the funds which invested for at least 30 months returned an invested capital multiple of 2.7x and a gross

[1] KKR & Co. L.P., Form S-1.

[2] Barbarians at the Gate: The Fall of RJR Nabisco is a book about the LBO of RJR Nabisco, written by Bryan Burrough and John Heyar, published in 1989.

IRR of 26.3%, comparing to a lower than 10% annual return of the S&P500 for the same period.[3]

In the Alliance Boots transaction, KKR was represented by Dominic Murphy, a leader of the firm's activities in the UK (see **Exhibit 2**).

Terra Firma Capital Partners

Terra Firma Capital Partners ("Terra Firma"), a UK based private equity firm, was founded in 1994 by Guy Hands. It was previous called Nomura's Principal Finance Group, once it was part of Nomura, a leading Japanese bank. It was a foremost firm in the private equity industry in Europe, having invested more than $20 billion in leveraged buyouts up until 2002, year in which it was spun out from Nomura as Terra Firma Capital Partners. In the subsequent years it completed several successful takeovers, among which was the €735 million transaction of WRG, the leading waste disposal operator in UK and the acquisition of Odeon and UCI, which were then merged, giving origin to the leading cinema operator in Europe.[4]

The Target

Alliance Boots was a multinational company listed on the London Stock Exchange, operating in the pharmaceutical, health and beauty industries, with corporate headquarters in Switzerland, and operational headquarters in the United Kingdom. It was founded in March 2006, as a result of the merger between two public firms – Alliance Unichem and The Boots Group.

Alliance Unichem

Alliance Unichem was a leading European healthcare firm, founded in 1997 with the merger between Unichem and Alliance Santé.

Since it was created, the firm had expanded through organic growth and acquisitions. It operated as a wholesaler and retailer of pharmaceutical, medical and healthcare products, and its primary activity consisted in the distribution of medicines to pharmacies, along with the provision of dispensing and advice to its patients. The Alliance Unichem Group distributed to approximately

[3] KKR & Co. L.P., Form S-1.

[4] In August 2007, Terra Firma acquired EMI for £2.4 billion. However, poor management and the financial crisis led to a write-off of this investment in 2011. By that time, Citi, the major lender of this transaction, took over EMI. This deal blemished Terra Firma's track record due to its disastrous outcome.

125,000 pharmacies, hospitals and health centers, and its largest operations took place in France and in the UK. The firm also operated 1,300 retail pharmacies in 5 European countries. By the end of 2005, it reported £9,171 million of revenue and an operating profit of £261 million **(Exhibit 3)**.[5]

Alliance Unichem's key areas of expertise were retail and wholesale in the healthcare market, which were the main drivers of shareholder value of the firm. In addition to the organic growth, the firm invested a cumulative amount of £396.4 million from 2002 to 2005 to acquire 224 retail pharmacies in the UK, Norway, Ireland and the Netherlands, and £71.2 million on the acquisition of businesses for the wholesale division.

Stefano Pessina was the indirect owner of Alliance Santé, and the merger granted him a seat on the Board of Directors of the newly merged firm. He was also the CEO of Alliance Unichem for 3 years, until 2004, when he was appointed Executive Deputy Chairman (see **Exhibit 2**). Pessina owned 30% of the shares of the company and he was responsible for its strategic development, which included the control and monitorization of acquisitions.

The Boots Group

The Boots Group was a health and beauty company, founded in the nineteenth century, operating in the retail and manufacturing sectors and managing approximately 1,500 health and beauty stores in 17 countries. For the year ended March 31st 2006, the company had revenues and operating profit from continuous operations of £5,027 million and £369 million, respectively, and a net assets book value of £1,652 million (**Exhibit 4)**.[6] By the end of the fiscal year of 2006, it operated three main businesses: Boots the Chemists ("BTC"), the Group's health and beauty retail business in the UK and in the Republic of Ireland; Boots Opticians ("BOL"), comprising the Group's optical and eye-care business in the UK; and Boots Retail International ("BRI"), which represented the firm's operations abroad.

BTC operations had three main business components: health business, beauty and toiletries and lifestyle. It ran more than 1,000 stores throughout the UK and in the year ended March 31st 2006 its revenues accounted for 86% of the Boots Group's revenues, along with 92% of trading profit (including discontinued operations). BOL, which was being integrated in the BTC business, had approximately 280 practices in the UK and accounted for 3.2% of the group's

[5] Alliance Unichem – The Boots Group, Prospectus.

[6] Alliance Unichem – The Boots Group, Prospectus.

total revenues. In the named financial year, this business suffered a trading loss of £3.5 million. On the other hand, the revenues of BRI amounted to £57.9 million in the 2006 financial year, and its trading loss decreased to £1.8 million, keeping the trend of loss reduction that it had been experiencing in the previous years.

Until 2006 the Boots Group also comprised another business unit, Boots Healthcare International ("BHI"), responsible for the manufacturing process. BHI had continuously achieved organic growth above expectations, delivering sales of £528 million at the end of the 2005 fiscal year, which represented a 5.8% year-on-year growth. In that same year, The Boots Group announced the sale of this business unit, once it entered the final phase of a four-year growth plan, which was completed in January 2006.

Over the three years prior to the merger with Alliance Unichem, The Boots Group refocused itself on its core health and beauty businesses, investing to become more modern, efficient and competitive in these industries.

Alliance Unichem and The Boots Group Merger: Alliance Boots

On October 3rd 2005, the Boards of Directors of Alliance Unichem and The Boots Group agreed on the terms of the merger of the two companies, creating a new one, called Alliance Boots. Both Boards felt that this merger would enable the creation of an international pharmacy-led and health company, with a stronger international position. They believed the merger would connect a management team with an astonishing track record in acquisitions (Alliance Unichem's) with one with proven retail, pharmacy and product development expertise (Boots'). It was believed the merger would lead to a better overall investment grade rating, incremental revenue potential from the increased availability of the firm brands across its larger network, and pre-tax cost savings of at least £100 million per year, by harmonizing buying prices, reducing administrative costs and consolidating both firms' distribution channels.[7]

The merger between these players was approved by the respective Boards of Directors on February 2006, and it was completed on July 31st 2006. Under the accorded terms, each share of Alliance Unichem was cancelled and its shareholders received 1.332 shares of Boots for each Alliance Unichem share on the completion date, effectively valuing the combined firm in

[7] Alliance Unichem – The Boots Group, Prospectus.

£8,564 million.[8] At this date, Alliance Unichem became a wholly-owned subsidiary of the Boots Group, and the group name changed to Alliance Boots. The merger ended up diluting Pessina's stake in the firm, leaving him with an interest of 15.05% on the new company.[9]

Alliance Boots' Operations

Alliance Boots was created with the main intention to scale up operations, to ultimately form the world's major pharmacy-led health and beauty group, and to capture synergies. To face an increasing demand towards health and beauty products, Alliance Boots established international retail and wholesale businesses, aiming to be one of the European leaders in pharmacy retail, which would be facilitated by a management team formed by a combination of the top representatives of both Alliance Unichem and The Boots Group (see **Exhibit 5** for management team information).

With operations in retail and wholesale, Alliance Boots owned approximately 3,100 outlets, of which 2,800 had a pharmacy, and a wholesale network of around 380 depots that served around 120,000 outlets.

In the wholesale industry, the firm positioned itself as the leader in the European market in the distribution of healthcare and pharmaceutical products and services. With the merger, Alliance Boots implemented an expansion plan, by investing in established regions and in new ones with major potential growth. By doing so, it aimed at achieving organic growth and increased revenues in the following years, and at improving its efficiency by decreasing its operational expenditures. This part of the business represented 61.7% of the revenues of the group.

The retail business unit, on the other hand, represented 45.0% of the group's revenues and aimed to capitalize the largest pharmacy chain in Europe.[10] UK remained the main target of the retail industry, fueling the growing path Boots was experiencing. The retail network in the UK comprised two businesses: the Health & Beauty and the Community Pharmacy, which jointly included more than 2,500 retail outlets, 1,000 of which were operated by the Community Pharmacy. These pharmacies tended to be small and had a strong emphasis on healthcare,

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[8] The 360 million shares outstanding of Alliance Unichem at the approval date would be translated into 482 million shares in the enlarged firm.

[9] KKR & Co. L.P. – Alliance Boots, Scheme of Arrangement

[10] Intra-group transactions represented the remaining (6.7%) of total revenues

advice, dispensing and other services. Alliance Boots also had operations abroad, running 550 pharmacies in Ireland, Norway, Netherlands, Russia, Italy, Thailand and Switzerland.

For the year ended March 31st 2007, Alliance Boots presented revenues and profit before interest and taxes of £14,608 million and £518 million, respectively, which were expected to grow strongly in the foreseeable future (**Exhibit 6** presents Alliance Boots financial projection in a business as usual scenario, **Exhibit 7** presents Alliance Boots' financial information as of March 31st 2007, **Exhibit 8** presents capital markets data and **Exhibit 9** presents a comparable companies' analysis for Alliance Boots).[11]

Yet, the good prospects for the firm were offset by some potential risks. Firstly, there was the possibility of failure of post-merger integration, once both Boots and Alliance Unichem were large companies, with their own culture and mission; secondly, the revenues of the firm were highly dependent on the consumer behavior trends; and thirdly, this industry was subject to complex regulation and legislation features, which could deteriorate the business model.

Industry Prospects

For some years, the pharmaceutical industry had been experiencing a strong market consolidation, with big players betting on growing through acquisitions, mainly to respond to constant changes in consumer trends and to keep R&D expenses under control. Yet, from 2005 onwards, both wholesale and retail subsectors within the industry had been growing below expectations, due to pressure from governments and regulators, which were demanding lower prices for customers. Even so, the industry was expected to continue to grow, due to an increased demand for beauty and health products, a greater focus on personal well-being, an increased awareness of personal care and other social and demographic trends.

There were several factors influencing the future of this industry and its intrinsic growth, from which two stood out. The first one regarded the growth in the world population, which was expected to increase by more than 1% annually, mainly driven by emerging markets, increasing the market for this industry;[12] and the second one concerned the increase in life expectancy, which would result in the rise of the demand for drugs and healthcare services, given that, on average, 75% of all pharmaceuticals sales were directed for people over 65 years old. [13]

[11] Alliance Boots pro-forma Annual Report, 2007.

[12] IMS Global Prognosis Report 2007-2021.

[13] Alliance Boots pro-forma Annual Report, 2007.

Besides demographics, there were other trends affecting the future performance of the industry:

The role of pharmacists: in Europe, pharmacists had been regarded as healthcare advisers, having an influence on the sales of drugs over the counter. Therefore, an increasing focus on personal care and well-being created an opportunity to enhance their perceived role and deliver a broader range of services.

Continuous market consolidation: consolidation in pharmaceutical wholesaling markets was expected to accelerate. Regulatory and market changes would likely increase pressure on smaller players, expanding the opportunities for market consolidation.

The pharmaceutical market: this market was expected to grow by more than 6% per year in the following 4 years, due to demographics and consumer behavior trends. This would originate a market with greater potential and, consequently, increased sales. [14]

The rise of generics: the surge in the demand for pharmaceuticals increased the pressure from governments to sell cheaper medicines and drugs, consequently enhancing generic drugs penetration, which not only led to a higher demand for wholesalers and retailers that were prepared for it, but also to a decrease in margins, once manufacturers would be the ones that would suffer the most.

Growth in the demand for direct distributions: due to tighter regulation and to increased penetration of generic drugs, pharmaceutical manufacturers were expected to stop selling via wholesalers and start selling directly to pharmacies. This trend represented the biggest threat for drug wholesalers.

Health expenditure: from 2001 to 2003, the healthcare expenditure as a percentage of GDP in OECD countries had increased from roughly 8.5% to 9%. However, from 2003 to 2005 this expenditure increased less than 0.1 percentage points, and this deacceleration was expected to keep pace, due to decreasing prices in this industry.[15]

Boots' Leveraged Buyout

Investment Thesis

Stefano Pessina felt that the structural changes in the pharmacy retail and wholesale markets in Europe would oblige Alliance Boots to accelerate the synergies from the merger between Alliance Unichem and The Boots Group, and to position itself as a pharmacy-led health, beauty

[14] IMS Global Prognosis Report 2007-2021.

[15] OECD Health Data, 2007.

and services-oriented business – opinion shared by Murphy, on behalf of KKR. Their motivations for acquiring Alliance Boots relied mainly on the fact that the firm was a market leader in the UK pharmacy, health and beauty market, a leading player in Europe wholesale market and a vertically integrated company.

Based on the profile of the firm, the consortium believed that there were opportunities to grow the business and increase operating margins. Additionally, KKR and Pessina believed there was scope to further internationalize the firm across several business areas, due to internal capabilities and industry trends. The fact that Boots was a trusted company in the UK further enhanced Murphy and Pessina's motivations to buyout Alliance Boots.

To make the company yield a considerable return in the retail business, KKR and Pessina intended to engage in several actions. Firstly, to expand the Boots brand, which was associated to expertise and trust, reinforcing the firm's position in the UK; secondly, to use the Boots pharmacy approach in other European countries; thirdly, to optimize UK operations by refurbishing, opening and relocating stores; fourthly, to optimize the internet offering; fifthly, to develop the role of pharmacists, matching the industry trend; and, lastly, to grow in Europe through acquisitions, following the trend of consolidation felt in the market. Regarding wholesale, the consortium envisioned to develop new delivery contracts, avoiding the pharmaceutical manufacturers bypass; to invest in generic drugs distribution; to increase efficiency by combining purchases, better managing margins and making use of improved scale economies; and to expand to new markets, such as Asia and Latin America. It was believed that this program, jointly with an accelerated integration of synergies from the merger, would increase top and bottom line results.

KKR's expertise in assessing capital resources and in M&A, along with Pessina's experience in successfully operating firms in this industry, were perceived as key to transform Alliance Boots in the next global leader in the healthcare services and beauty industries. By accelerating the revenues growth, improving cost efficiency, pursuing a strategy of internationalization and growing through buy-and-build, Murphy and Pessina felt it would be possible to boost the firm's enterprise value (see **Exhibit 10** for the consortium expectations on the firm's operations with the LBO).

On March 9th 2007, KKR and Pessina announced their intention to acquire 100% of Alliance Boots by offering £10 per share.[16] Additionally, they would buy the firm's entire outstanding

[16] Non-binding preliminary offer.

debt, to avoid covenant violations due to the buyout and to refinance it under their own negotiated terms and restrictions. Due to Pessina's status as a potential buyer of the firm and the consequent conflict of interests, Stefano Pessina and board member Ornella Barra were recused and did not participate in the Board discussions regarding the recommendation to Alliance Boots shareholders, nor in any other discussion concerning competing bids (see **Exhibit 11** for Alliance Boots Board of Directors composition). [17]

Backed by Murphy, Pessina created AB Acquisitions Holding, a structural vehicle controlled by KKR and by Alliance Santé Participations ("ASP"), meant to implement the LBO of Alliance Boots, each one having a 50% stake. [18]

Leveraging the Business

Murphy and Pessina intended to heavily rely on debt to finance a large portion of the acquisition. Leveraging the business was a common feature in the private equity world, once it allowed the new shareholders to boost their returns by simply repaying the debt. Thus, to finance the Alliance Boots acquisition, the consortium expected to get loans from banks, which would be ranked as senior secured debt. Along with these, a Revolving Credit Facility ("RCF") would be used, intended to help financing the day-to-day operations and net working capital needs. Finally, mezzanine debt would also be raised, which was riskier than bank loans, ranking junior to them. [19]

Even though leverage had the potential to boost returns for shareholders, there were some constraints that needed to be respected. Creditors, especially the senior ones, were expected to be protected by financial covenants to guarantee that their facilities would be repaid. In the event of covenants' violation, lenders had the right to accelerate the debt payments, cancel commitments, demand repayments and enforce guarantees and security, forcing the firm to file for bankruptcy. Hence, the choice regarding the new capital structure had to take into account the expected performance of the business (**Exhibit 12** presents the expected debt terms and expected covenant levels for this LBO).

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[17] Ornella Barra was the Wholesale & Commercial Affairs Director and a long-term partner of Stefano Pessina.

[18] ASP was a vehicle whose Stefano Pessina and Ornella Barra were Directors and whose the ultimate owner was a family trust. It was the former owner of Alliance Santé that originated Alliance Unichem.

[19] Mezzanine debt has cash interest and a PIK (payment in kind) element, which is added to the debt. The PIK element accrues and adds to the debt. The accrued amount capitalizes every period and is paid at the time this debt facility is to be repaid.

Regarding the equity part it was expected to be split between a subordinated shareholder loan, whose interest accrues over time, and ordinary shares, the residual claim on the firm. These ordinary shares would then be split between the management team - sweet equity - and the institutional investors.[20] **Exhibit 13** shows the sources and uses of funds for a £10/share offer.

The well-defined strategy for Alliance Boots' operations and for the financing structure boosted Murphy and Pessina's confidence for the takeover. They believed this deal had an abnormal potential, in which they could divest five years after having invested and surpass the industry threshold of a cash return of 3x and an IRR of 25%.[21]

The Bidding War: KKR vs Terra Firma

The initial proposal of KKR and Pessina, made on March 9th, ended up being rejected by Alliance Boots' Board of Directors, claiming it did not compensate the firm's shareholders - neither for the firm fundamental value and attractive prospects, nor for the synergies' opportunities still to be integrated – due to the merger between Alliance Unichem and The Boots Group in the previous year.

On April 1st, a revised cash offer of £10.40 per each share of the firm was presented, still subject to some due diligence. However, on April 6th, Terra Firma, jointly with The Wellcome Trust, a biomedical research charity, publicly demonstrated their interest on acquiring Alliance Boots, by offering £10.85 per share, in cash, to the Board of Directors. [22]

Terra Firma's proposal forced KKR to accelerate the due diligence process and on April 16th it issued a letter to the Board of Alliance Boots stating its interest in acquiring the business, for the price offered earlier that month. Due to the higher proposal from Terra Firma, the Board declined KKR and Pessina's offer, which led them to increase the offer price up to £10.90 per

[20] Sweet equity stands for the equity stake that the management team is entitled to and its main goal is to align interests between investors and executives. It represents 10%-20% of the firm's stake in exchange for 1-2x the management team's annual salary.

[21] The returns are driven by two factors: EV growth, which can be decomposed into EBITDA growth and multiple arbitrage; and deleveraging the business, which is the result of repaying the outstanding debt, increasing the value for the residual claimers.

[22] The Wellcome Trust was a biomedical research charity, founded in 1936 with the main objective to fund research to improve human health.

share, in cash. After this counteroffer, Terra Firma announced that HBOS,[23] a banking and insurance firm, had joined the consortium and presented a new cash offer of £11.15 per share, showing their willingness to acquire Alliance Boots, regardless of the costs they would incur in.[24]

The negotiations between the two consortiums and Alliance Boots were intensifying, with both groups relinquishing potential future returns to win the bidding war. These increased offers benefitted the current shareholders of the firm, while hurting the investors backing the respective consortiums.

The Decision

In face of Terra Firma's counteroffer, Murphy and Pessina had to decide whether to withdraw their proposal or to improve it, while carefully considering the implications of each action. The consortium had to offer at least a 36.8% premium over the undisturbed share price to secure a deal, which would decrease the return of their investment.

At this point, Murphy and Pessina were battling against the clock. They had to evaluate the feasibility of the investment, given the expected operating model for the firm, and assess whether the premium was adequate. It was certain they had to understand how much should be paid to convince the Board of Directors to accept their offer, driving Terra Firma out of competition. Yet, a greater concern was implied: would that price enable KKR to exit within five years with a good realized return for their LPs, or would it lead to a disastrous outcome instead, with lower returns than the industry threshold, breached covenants and massive amounts of debt to be repaid at the shareholders' cost?

[23] HBOS was a banking and insurance company created in 2001 with the merger between Halifax and the Bank of Scotland.

[24] KKR & Co. L.P. – Alliance Boots, Scheme of Arrangement.

Teaching Note

Synopsis

Dominic Murphy, on behalf of KKR, and Stefano Pessina, the Executive Deputy Chairman of Alliance Boots, had to decide whether to raise the offer they had made to buyout Alliance Boots, a company operating in the pharmaceutical, health and beauty industries. This consortium had made a non-binding preliminary offer in cash of £10 per share, but another private equity consortium, led by Terra Firma Capital Partners, was also interested in buying the company out and raised the bid up to £11.15 in cash. Murphy and Pessina had to analyze the option of withdrawing the offer and the option of raising the bid, taking into account the expected outcome of the investment.

Suggested Teaching Plan

This case is designed for a Corporate Finance and/or Private Equity course. It should be accompanied by Chapters 1, 3, 4 and 5 in Rosenbaum, Pearl, *Investment Banking: Valuation, Leveraged Buyouts and Mergers & Acquisitions*, 2nd Edition, (NY,NY: J.Wiley, 2004); Chapters 12 and 24 in Lerner, Hardymon, Leamon, *Venture Capital & Private Equity: A Casebook*, 3rd Edition, (NY,NY: J. Wiley, 2004).

Suggested Questions

1. Is Alliance Boots an attractive target for a LBO?
2. What are Pessina's motivations for buying out Alliance Boots?
3. What is the value of Alliance Boots on a business as usual scenario? How much should the consortium pay for the enterprise value of the firm (100% of all outstanding debt and equity)?
4. What are the main risks of this investment? Present the debt and cash schedules, based on the given expected operating model, debt terms and S&U.
5. Based on the previous valuation, KKR's operating model and on the cash and debt schedules, what are the expected IRR and cash return for this buyout, assuming an exit in 5 years? (*Hint: assume no multiple arbitrage and use the multiple approach to get the enterprise value at the exit year)*

6. Why do private equity firms share the ordinary equity with the management team? How much of the value is being created by leverage?
7. What is the maximum amount KKR is willing to pay per share? Should KKR invest?
8. Assuming a carry of 25% and a hurdle rate of 5%, is this deal attractive for the LPs?

Opportunities for Student Analysis

The discussion of this case is divided into three parts. Firstly, students should figure out the feasibility of a leveraged buyout on Alliance Boots and the motivations of Stefano Pessina; the discussion then evolves to a valuation part, where the class should assess the fair value of the target firm and the risks associated with this investment; and lastly, students should discuss and measure the expected returns of this investment and its key drivers, assessing the impact of the existence of another bidder on returns.

Alliance Boots as an LBO candidate

A good starting point for the discussion would be the assessment of Alliance Boots as a candidate for a leveraged buyout. Students should point out the main characteristics of the firm that make it a good LBO target as well as any shortfalls it may have.

Strong cash-flow generation: given the cash-flow projections on Exhibit 6 of the case, it is possible to see that Alliance Boots generated positive cash-flows from operations in 2007, which were expected to increase every year until 2012 (see **Exhibit TN 1**). A strong and robust cash-flow generation shows that the firm can incur on high levels of debt, with good terms and conditions.

Cyclicality: often, private equity firms seek non-cyclical industries to perform their leveraged transactions. When a firm's operations performance is heavily subject to external factors, the degree of control that the private equity firm has over it decreases. Being the pharmaceutical industry a non-cyclical one, improves Alliance Boots' potential as a LBO candidate.

Leading and defensible market positions: the target firm was created with the intention to be the world's leading pharmacy-led health and beauty group. By the time of the case, the firm already was one of the largest pharmacy chain in Europe and the European leader in the distribution of healthcare and pharmaceutical products and services. Also, students should address the industry's opportunities for market consolidation. The accelerated consolidation in the pharmaceutical wholesaling market enabled the firm to grow through acquisitions and improve its market position.

Growth opportunities: this industry showed good future prospects with potential growth opportunities, mainly due to demographics, ageing population, continuing and accelerated market consolidation and world pharmaceutical market growth rate. Also, the firm itself had internal factors that could be translated into opportunities to grow, such as the possibility to further internationalize the business and become exposed to new markets; to develop the internet offering, being able to keep technology's pace; and to develop the role of pharmacists, matching the industry trend.

Efficiency enhancement opportunities: due to the merger, it was possible to decrease operational costs by harmonizing buying prices, reducing administrative costs and consolidating distribution channels. Also, by relocating, refurbishing and opening stores, Alliance Boots could further optimize its operations.

Proven management team: Alliance Boots' top management team was composed by experienced people in the industry. Based on Exhibit 5 of the case, it is possible to infer that every member in the management team had at least 2 years of experience and that none of them was disposable, once all of them came either from The Boots Group or Alliance Unichem and none of them was set aside at the time of the merger.

Strong asset base: private equity funds seek firms with a strong asset base to be posted as collateral. As leveraged buyouts rely on massive amounts of debt, lenders often ask for a collateral as a guarantee and the higher the quality of a firm's assets, the better the conditions investors can get from creditors. In the case, there is not enough information to assess the quality of the assets of Alliance Boots, being only possible to assess their value - The Boots Group had almost £1,268 million in Property, Plant and Equipment in 2006 and Alliance Unichem had £350 million in 2005.

Valuation: the value of the firm stands as a key factor when determining whether a firm is a good target for a leveraged buyout, once the higher the entry price, the lower the returns, ceteris paribus. Nonetheless, this topic should be addressed in the second part of the discussion.

Stefano Pessina's motivations

Why would Stefano Pessina, the Executive Deputy Chairman of the firm, want to takeover Alliance Boots? Pessina, as stated in the case, felt that the structural changes in the European market would require Alliance Boots to position itself as a pharmacy-led health and beauty and services-oriented business. He also wanted to accelerate the synergies from the merger between Alliance Unichem and The Boots Group.

Besides the operational improvements that Stefano Pessina wanted to implement, there were other factors influencing his decision:

Vertically integrated company: as a vertically integrated company, Alliance Boots enjoyed an increased control over the supply chain and distribution channels, enabling it to capture better profit margins and to ensure quality standards for its customers. The ownership over the supply chain allowed the firm to deliver more value to its shareholders.

Exposure: Pessina was the owner of 15.05% of the firm's shares and as he really believed this firm could create shareholder value, he wanted to be more exposed to the firm. By joining forces with KKR and being entitled to 50% of the firm, Pessina could realize a much higher return if the firm grew as he was expecting.

The instructor should raise the question whether such efficiency gains could be achieved by Pessina without buying the company and taking it private. When a firm is public it is subject to analysts and investors' short-term oriented judgements, and if something goes off-track the firm's market value can decrease. Taking it private would enable Pessina to act, without being punished by the market. The instructor could also make a comparison between this and the Dell case, where the CEO also bought the firm he was managing in 2013 by $24 billion, backed by Silver Lake, a private equity fund. Michael Dell, the firm's CEO, believed the market wasn't valuing the company as it should, stating that investors and analysts were too focused on the short-run, leading to an undervaluation of the firm. Hence, he announced his intention to take the firm private, so that he could act more aggressively in his strategies without being punished by the market sentiment.

Alliance Boots' intrinsic value

The valuation of Alliance Boots introduces the second part of the discussion, which focuses on the intrinsic value of the target firm and the main risks associated with this investment. The instructor may continue the topic left for development in the first part of the discussion, by referring that valuation plays a big role in LBOs, once it is a key driver of the returns, and ask the class to discuss about the fair value of Alliance Boots.

Valuing a company is often a difficult and subjective process. There are several methods to value a firm, such as the discounted cash flows ("DCF"), Comparable Companies Analysis ("Trading Comparables"), Precedent Transaction Analysis ("Transaction Comparables"), a Regression Analysis between a multiple and sales growth, LBO Valuation, among others. Given the information available from the case, three of these methods should be calculated: Trading Comparables, DCF and LBO Valuation.[25]

Trading Comparables: this methodology provides a ballpark valuation and it can be used under the assumption that similar companies provide a relevant reference point for valuing a given target, once they share business and financial features, performance drivers and operational risks. Being quick to use, simple to understand, a market based approach and commonly used in the private equity industry are its main advantages. The core of this exercise is to select the peers that are the most similar to the target firm; and to perform the valuation. Since the case already provides the best peers for Alliance Boots (Case Exhibit 9), students should assess the valuation range for each multiple available. **Exhibit TN 2** presents a summary of the Trading Comparables' valuation.

DCF approach: it is more theoretically sound but at the same time more complex. There are three main methods within this approach: WACC, FTE or APV. The first two methods should only be used when there is a clear target for the leverage ratio. As the case provides information regarding the expected amount of debt outstanding at each year instead (Case Exhibit 7), the latter should be the most appropriate. Also, debt and leverage ratios tend to change over time, which means APV is a more flexible approach to value a firm, allowing at the same time to differentiate the value that is being created by operations from the value that is being created through financing decisions. The starting point of this method is the calculation of the cost of capital, by assessing the unlevered beta of Alliance Boots. Even though it is provided in the case, the unlevered beta for the firm should not be used, once it is subject to a massive market noise. The median of the peers should be used instead, as a proxy for the beta of the firm (see

[25] The LBO method should only be addressed in the returns part of the discussion.

Exhibit TN 3).[26] Having the unlevered beta, risk-free rate and the market risk premium, the unlevered cost of capital can be calculated, as done in **Exhibit TN 4**, followed by the calculation of the cost of debt of the firm.

To assess the cost of debt of the target firm, the yield of the firm's tradable bonds can be used as a proxy. Even though the yield is not a cost of debt, it stands as a good proxy for low risk firms. Moreover, it is always more conservative than the actual cost of debt. On the Exhibit 7 of the case, information regarding the firm's tradable debt is provided, which enables the class to assess the implied yield of the firm's debt (see **Exhibit TN 5**).

Having the discount rates defined, the tax shields of debt should be discounted at the cost of debt (see **Exhibit TN 6.1**) and the unlevered FCFs at the unlevered cost of capital. For the terminal value, two approaches can be used: based on a long-run growth rate or based on an EV multiple. Summing the present value of the tax shields, the discounted unlevered free cash-flows, the terminal value and subtracting the net debt and other net financial liabilities the Alliance Boots' intrinsic value according to the DCF approach can be inferred (**Exhibit TN 6.2** shows the discounted cash-flows calculation and **Exhibit TN 6.3** shows the net debt and other net debt financial liabilities impact on equity).[27]

Even though all these approaches return a value for the firm, that is not the main purpose of this exercise. In M&A, the transaction value is always subject to a complex negotiation process between the buy-side and the sell-side, thus a valuation range should be the main output of a valuation (**Exhibits TN 7.1 and 7.2** present a sensitivity analysis for the discounted cash-flow approach and a general overview of the previous exercise, respectively). However, for the purpose of this analysis, a value of the firm should be inferred, to allow for the calculation of returns. Based on these results, some takeaways should be highlighted:

The multiples approach is widely used in the private equity industry, namely the EV/EBITDA and the EV/EBIT approaches, due to EBITDA and EBIT's proxy to cash. Among these two methods, EBIT turns out to be a better proxy for cash than EBITDA. Also, **EV/EBIT** is the one that gathers more consensus in the market regarding the valuation for this industry, due to the smaller valuation range, thus being the best multiple among the ones given in the case.

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[26] Both the median and the average values can be used. This teaching note uses the median, once it allows for the control of outliers.

[27] The tax shields do not grow in perpetuity, contrarily to the free cash flows unlevered

The DCF approach: from the valuation methodologies discussed, the DCF is the more theoretically sound, as it takes into account growth opportunities and is a much more complex exercise. However, it is highly sensitive to many assumptions, including the perpetuity growth rate and the discount rate – **Exhibit TN 7.2** shows that the DCF with the perpetual growth rate method is among the approaches with a higher valuation range. The **DCF with the exit multiple** solves part of the problem, once even though it is still sensitive to the discount rate, it becomes a much more solid approach regarding the perpetuity, resulting in a much smaller valuation range (**Exhibit TN 7.2**). Moreover, using an EV multiple instead of a long-run perpetuity growth rate enables the calculation of the value of the firm based on the market assessment for this specific industry.[28]

Based on the results from the valuation exercise, students should conclude that there are two preferred methods to infer the value of Alliance Boots: EV/EBIT multiple ad DCF with the EV exit multiple.[29]

Investment risks

The instructor might then ask if there were any risks related to this investment. To answer this question, students should address two types of risks: firm specific and generic LBO risks.

Firm specific risks: the post-merger integration risk stood as the major one – 66% to75% of M&A activity does not create value for the acquirers, due to failure in managing the integration of companies after a merger.[30] As stated in the case, both Alliance Unichem and The Boots Group were big companies with their own missions and cultures, and a poor management of the integration of these firms could dictate the failure of this investment. There were also other risks, specific to firms in this industry, such as the tighter regulation from governments, which could ultimately decrease the company margins; the growing demand for direct distributions, destroying value for the wholesale business; the expected deacceleration of health expenditure;

[28] While the perpetuity growth rate is the same for every firm in the same market, the exit multiple is specific to each industry and firm.

[29] Any other reasonable approach may be used. Due to the preference of EV/EBIT over the other multiples presented in the case, the entire analysis is performed based on this multiple.

[30] *Perspectives on merger integration*, McKinsey & Company, June 2010.

and the rise of generics, that could hurt Alliance Boots alike companies that were still developing generic drugs services.

Generic LBO risks: leveraged transactions show several risks for the investors, being weak management and financial distress the major ones. These transactions are based on a massive expected performance enhancement, which requires a solid management team with expertise, experience and incentives to produce the expected outcome. Regarding Alliance Boots, the management team's expertise and experience was not an issue, as previously stated; however, the risk of misalignment of interests was real and, if poorly managed, it could lead to lower levels of productivity, lower cash-flow generation, and consequently lower returns and higher probability of shortage of cash to face debt services. A leveraged buyout is known for the large amounts of debt used to finance acquisitions and if operations performance falls below expectations, or if there is any external unexpected event, such as an economic recession, litigations, changes in regulation or changes in the political environment, the probability of not meeting debt obligations increases, which can lead to a default situation due to the violation of covenants, or even default on interest or principal payments.

The estimation of cash-flows from operations, on a leveraged buyout scenario, is thus key to assess the financial distress risk of this investment. The calculation of the debt and cash schedules, based on the information from the Case Exhibits 11 and 12, shows that the estimated levels of cash-flow coming from operations was enough to cover the debt services during the first 5 years of operations (**Exhibits TN 8.1 and 8.2**). However, the credit ratios – leverage, cash and interest cover – should be compared with the covenants given by the Case Exhibit 12, to effectively estimate the financial distress risk of this investment. **Exhibit TN 9** provides the credit ratios, under the expected operating model and debt structure of this deal.

The discussion of this second part should end with students concluding that there is some financial distress risk, since on years 1, 2 and 5 of the investment the expected cash cover lies below the covenant level. When credit ratios do not meet the accorded terms, lenders have the right to accelerate the debt payments, cancel commitments, demand repayments and enforce guarantees and security. However, the instructor should state that the exercise of setting up covenants is highly dependent on negotiation skills and on the track record of the investors. Being one of the most powerful private equity firms in the world with a good track record, as stated in the case, conveys to KKR a negotiation power that enables it to lower the covenant levels until feasible values.

Returns

After assessing the fair value of Alliance Boots and the risks associated with the investment, the instructor should address the expected returns of this investment. [31]

Having defined the enterprise value at the entry year, assuming no multiple arbitrage and based on the previously calculated debt and cash schedules, the enterprise and the equity values of the firm for the exit year can be estimated (see **Exhibits TN 10.1 and TN 10.2**).[32]

Based on the previous exercise the expected returns can be addressed, based on two metrics: the internal rate of return ("IRR") and the total value to paid-in multiple ("TVPI"), commonly known as cash return or money multiple, which are the most common ways to measure returns in private equity.[33] These returns can be further decomposed into institutional and management returns; and by value driver.

Institutional and management returns: as stated in the case, the equity value is composed by a subordinated loan and the ordinary equity, where 20% of the latter is given to the management team. Besides the annual salary that the management team is expected to receive, private equity funds usually offer 10-20% of the firm's stake to management in exchange of 1-2 times its annual salary, with the main intention to align incentives between the equity sponsors and the management team. By having a stake of the firm, the management team payoff is related to the value it creates, meaning that the better the performance of the firm, the higher the management team's payoff. Also, for multibillion-dollar firms where the management team already owns a significant number of shares of the firm, the executives are usually asked to rollover the proceeds from the sale of shares, investing together with the institutional investors in the subordinated loan, to further align the incentives between them and the investors. However, in the Alliance Boots case, the management team owned less than 0.1% of the firm shares, leading to a cash-in amount of £6.23 million, through the sale of shares, which was not significant for a firm with a multibillion-dollar dimension (see **Exhibit TN 11** for the institutional,

[31] This teaching note uses the DCF with the EV multiple on perpetuity approach to assess the fair value of Alliance Boots.

[32] In the entry year, the equity value decreases by the amount of fees expected to be paid, meaning that shareholders are the ones who bear this expense.

[33] The TVPI is commonly used within the private equity industry and it is calculated by dividing the cumulative distributions to equity holders by the total capital they had invested. Even though it is widely used, the IRR is preferred over it, once it takes into account the time value of money and it is the one that is used against benchmarks.

management and total equity returns, under the assumption that the management team invests 2 times its annual salary for a 20% stake and **Exhibit TN 12** for the management rollover simulation).

Returns by value driver: besides the distribution of the returns among the relevant parties, the drivers of these returns should also be addressed. To perform this analysis, the returns should be decomposed into its key value drivers – EBITDA or EBIT growth, multiple arbitrage and deleveraging effect. By doing so, it is possible to realize that the major driver of returns is the EBIT growth, being responsible for 87% of the value creation, being the deleveraging effect the responsible for the remaining 13%, under the assumption that there is no multiple arbitrage. **Exhibit TN 13** presents the returns by value driver.

Industry threshold

Based on the valuation of £11.67 billion and with a debt issue of £6.55 billion, the equity value was expected to more than quadruple in a period of 5 years (the total equity TVPI with an entry in 2007 and an exit in 2012 is 4.13x). However, the fact that Terra Firma was also bidding for Alliance Boots led to an increased offer price for the firm. In a non-competitive environment, the assessment of an investment turns out to be an easier process; however, under a bidding war, investors have to assess the maximum amount they are willing to pay for a firm, avoiding overpayment situations and that amount is what returns a 25% IRR or a 3x cash return - the industry threshold. This valuation represents the LBO valuation mentioned in the first part of the discussion, where it is possible to infer the implicit valuation based on a target IRR. **Exhibit TN 14.1** presents the valuation that returns an IRR of 25%, ceteris paribus – Enterprise Value of £13.13 billion - which represents a 51.9% premium over the undisturbed share price for the equity part of the firm (**Exhibit TN 14.2**).

Based on the LBO valuation, the consortium was willing to pay at most a 51.9% premium, which was higher than the 36.8% offered by Terra Firma's consortium. KKR and Pessina still had scope to realize a good return on this investment. The higher the premium, the higher the probability of winning the bidding war, and as long as the premium over the undisturbed share price did not surpass the 51.9%, the consortium formed by KKR and Pessina could increase the offer price (see **Exhibit TN 14.2**).

Attractiveness to the Limited Partners

To finish the discussion, the instructor should ask students if they believed this investment was attractive for Limited Partners ("LPs"), assuming a 5% hurdle rate and a carry of 25%. To assess the attractiveness of this investment, it is necessary to discuss if it was profitable and better than a reference benchmark.

Profitability: the purpose of this analysis is to discuss whether the IRR for the LPs was higher than their cost of equity. To calculate the internal rate of return for the LPs, the carried interest - 25% of the returns were entitled to the General Partners ("GPs") - and the hurdle rate - only after having a return of 5%, the GPs were entitled to the carry – should be considered (see **Exhibit TN 15.1** for the IRR calculation). Having the unlevered cost of equity, the D/E ratio, the tax rate and the cost of debt of the LPs, it is also possible to calculate the cost of equity for the LPs, under the Modigliani-Miller approach, as done in **Exhibit TN 15.2**. The CAPM approach could also be used, however the betas of debt were needed to perform that analysis, which are difficult to obtain. After assessing the IRR and the cost of equity for the LPs, it can be concluded that the IRR outperformed the levered cost of equity (20.76% against 8.58%), meaning this LBO was potentially a value-enhancing investment for the LPs.

Comparing against a benchmark: for this investment to be fully attractive for the LPs, it should be tested against a benchmark. A good benchmark is the FTSE 100, the market proxy for the UK, which was expected to return 10.38% a year. To perform this analysis, it is needed to simulate an investment strategy on FTSE 100, with the same capital structure, time span, hurdle rate and carry and compare the IRR of this investment with the one LPs were expected to obtain with the LBO of Alliance Boots. A similar calculation as the one performed on **Exhibit TN 16** concludes that, in fact, the LBO returns more value to LPs than a leveraged investment on FTSE 100 and that as a LP it was preferable to invest in this LBO, which was expected to return an IRR of 20.76%, than on the market, whose expected IRR was 11.02%, making it an attractive investment.[34]

To finish the discussion, the instructor should highlight and recap the main topics covered in the class – what makes a good LBO target, valuation, returns and its drivers – and state that, given the information from the case and some reasonable assumptions, Dominic Murphy and Stefano Pessina had scope to raise the bid and still be above the industry threshold.

[34] From a return-only perspective

Epilogue

On April 24th 2007, the consortium formed by KKR and Stefano Pessina announced an increase in the offer price up to £11.39, which represented a 39.8% premium, over the share price of March 8th.[35] After the announcement, Terra Firma's consortium withdrew its potential interest in acquiring Alliance Boots and the KKR consortium ended up acquiring it. With 968 million shares outstanding and a net debt value of £1,057 million, KKR and Pessina paid a total amount of £12,083 million (excluding fees), from which £8,991 million were financed through several types of debt and the remaining £3,092 million were sourced from KKR Limited Partners and Stefano Pessina (see **Exhibit TN 17** for the actual financing structure).[36]

For 5 years, Alliance Boots experienced an impressive performance enhancement, with its EBITDA growing to £1,443 million in 2012, from £779 million in 2007.[37] In June of that same year, Walgreen announced it was buying 45% of Alliance Boots for $4.0 billion in cash and for 83.4 million shares of its common stock (equivalent to £4,192.86 million), with the option to buy the remaining 55% on the following 3 years. In the end of 2014, it exercised its right and bought the last 55% for $5.3 billion in cash plus 144.3 million shares of stock (equivalent to £9,237.10 million).[38] With the sale to a strategic buyer willing to pay for synergies, KKR and Stefano Pessina's investment (total equity) returned an IRR of 26% and a money multiple of 4.34x (see **Exhibit TN 18**).

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[35] Scheme of Arrangement KKR – Alliance Boots

[36] Bloomberg

[37] Annual Report 2012

[38] http://investor.walgreensbootsalliance.com/releasedetail.cfm?ReleaseID=889181, sourced on 04 July 2017. The equivalent values in GBP were sourced from Bloomberg.